New Brunswick's Perspective on the Equalization Program

Submission to the Federal Equalization Panel

Hon. Jeannot Volpé, Minister of Finance

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Introduction

The federal Equalization Program has been a cornerstone of Canadian fiscal federalism since its inception in 1957. Its importance cannot be overstated, with the principle of making equalization payments enshrined in section 36(2) of the *Constitution Act, 1982*:

> *Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.*

The objective of the Equalization Program has been to raise the per capita revenue-raising capacity of provinces to a standard level, such that all provinces have the ability to provide reasonably comparable levels of public services and taxation to their citizens.

The Equalization Program plays a major role in leveling the playing field across provinces. Citizens of equalization-recipient provinces benefit from levels of services and taxation that otherwise would not be possible.

The constitutional commitment to equalization refers not only to reasonably comparable levels of public services, but reasonably comparable levels of taxation. All governments in Canada recognize the importance of being competitive in today's increasingly global economy. Competitiveness requires lower taxes, quality public services and infrastructure, and a strong social safety net. Governments are striving to make their taxation systems more competitive while delivering essential, quality public services. The Equalization Program is a critical tool for less-affluent provinces to achieve these objectives and move towards greater self-sufficiency.

The program has evolved considerably since its inception. For example, the program's revenue coverage has been broadened to include most all provincial-local revenue sources, which provides for a comprehensive measure of each province's ability to raise revenues.

Since the early 1980s, a few significant developments in particular have served to constrain equalization entitlements. In 1982-83, the program standard was changed from a national-average standard, which took into account the fiscal capacity of all ten provinces, to a representative five-province standard. A ceiling provision was also introduced at that time, and subsequently removed from the program. Beginning 1999-2000, revenue coverage of revenues from the sale of goods and services was lowered. These measures have served to weaken the program's ability to ensure the constitutional commitment is met.

The new federal Equalization framework, announced in October 2004, has resulted in fundamental changes to the program. Most importantly, total entitlements will no longer be formula-determined but will be determined by legislation. For 2004-05 and 2005-06, allocation is fixed and recipient provinces are not equalized to the same per capita standard level. For 2006-07 and beyond, the allocation mechanism is uncertain.

The recent offshore accord deals for Newfoundland and Labrador and Nova Scotia – which are outside of the Equalization Program – have exacerbated fiscal disparities that the Equalization Program is designed to reduce. This has resulted in a number of provinces seeking bilateral, one-off deals with the federal government.

New Brunswick's Perspective on Recent Developments

New Brunswick has a number of concerns with recent federal initiatives as they relate to the Equalization Program and the principle of equalization in general.

In regards to the new federal Equalization framework, issues from a New Brunswick perspective relate to the overall funding level of the program and the uncertainty over, and possible direction of, future allocation:

- The funding level of $10.9 billion for 2005-06 simply returns the overall program payout to its 2000-01 level.
- Combined with the 3.5% annual escalator for future years, funding levels will be inadequate to ensure the constitutional commitment is met.
- Uncertainty in regards to allocation for 2006-07 and beyond is having a destabilizing effect on fiscal planning, particularly for the coming fiscal year.
- The federal panel has a broad mandate and is being asked to examine fundamental changes to the program and make recommendations on the future of the program in a very narrow timeframe.
- A number of issues being considered by the panel – e.g., macro formula; expenditure need – have been examined previously and were not implemented for a number of reasons; they would have significant implications on the program if they were.

New Brunswick has sought enhancements to the Equalization Program for many years, and welcomes the additional funding in the short-term that results from the new framework. However, the province is concerned that the level of funding is still not adequate, and is concerned with the fundamental changes – and the uncertainty – brought about by the new framework. It is the province's view that the new framework is an interim arrangement leading to a renewal of the program.

The most fundamental element of the panel's mandate is to advise the federal government on an allocation mechanism. This, however, is to be done in the context of a "fixed pool", which will contribute to re-distributional effects across provinces. In this environment, a mechanism for determining the annual eligibility of provinces for equalization must also be considered. Furthermore, the panel has been asked to consider indicators that can be used to evaluate the program's overall funding level in the future. These issues result from the use of a "fixed pool" as opposed to a formula-determined level of entitlement.

Many of the issues being considered by the panel would change the complexion of the Equalization Program and result in significant changes to its distribution. The panel must be aware that seemingly minor changes in provincial shares can have significant financial implications. For example, in a $10.9 billion program, a change from 10.0% to 9.8% of

entitlements represents a $22 million change in entitlements. While the change in share itself is relatively minor, it has a significant impact on entitlements, particularly for a smaller province. Changes to allocation will have a direct bearing on a province's ability to provide reasonably comparable levels of public services and taxation.

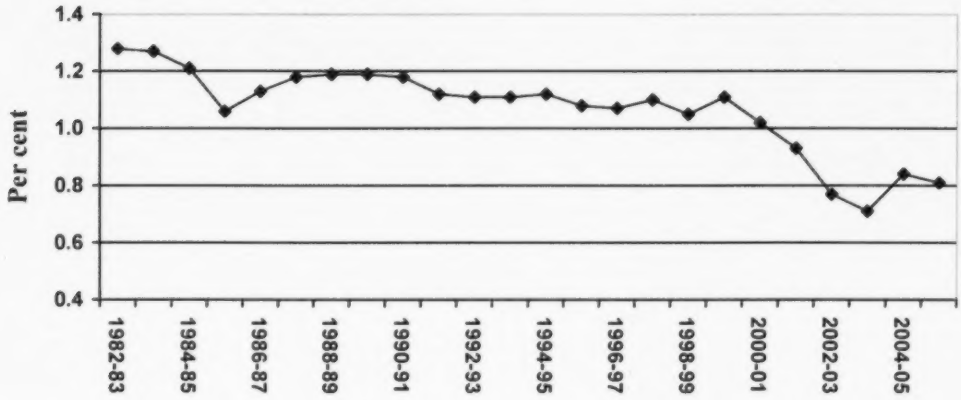
The panel is to report to the federal government on its recommendations by year-end, which the federal government will then consider in determining an allocation mechanism for 2006-07 forward. Given the importance of equalization funding for New Brunswick and other provinces, a more timely decision is required by the federal government on funding allocation for 2006-07.

The recent offshore deals, and other special arrangements, have served to exacerbate fiscal disparities that the Equalization Program is designed to reduce. This is inconsistent with the spirit and intent of the program, and the principle of equalization in general. Bilateral arrangements outside of the program should not undermine the Equalization Program.

Importance of Equalization

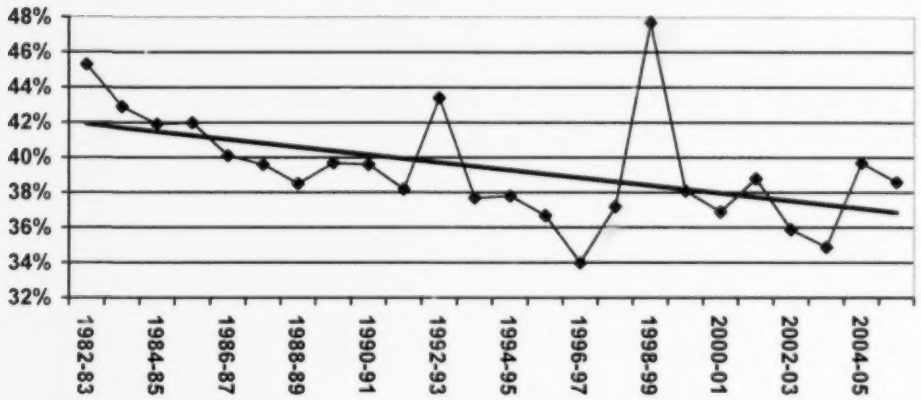
The Equalization Program plays a major role in reducing fiscal disparities within the federation. However, relative to the size of the overall economy, it represents a considerably smaller share than in the past, and will likely continue to decline.

Equalization Entitlements as a Share of National GDP



In New Brunswick, federal transfer payments comprise 38.6% of the province's revenues. Overall, the federal share has trended downwards since the early 1980s, with the province increasing its reliance on own-source revenues. The new Equalization framework, combined with additional health care funding, has contributed to a ratcheting-up of the share in 2004-05; the share is anticipated to decline in the future.

Federal Transfers to New Brunswick as a Share of New Brunswick Revenues



The Equalization Program contributes $1.348 billion, or 22.1% of revenues in New Brunswick, in 2005-06. To put into context what this means to New Brunswick, equalization funding represents nearly 75% of total spending in the Department of Health and Wellness; it exceeds the province's $1.2 billion budget for education and post-secondary education; and it exceeds the amount of revenues that the province derives from personal and corporate income taxes and capital taxes combined.

New Brunswick's Position

It remains New Brunswick's contention that the current Equalization Program is inadequate and that it does not meet the spirit and intent of the constitutional commitment. Considerable fiscal disparities continue to persist among provinces.

New Brunswick's position on the Equalization Program has been set out in a number of forums over the past five years. The following documents and submissions setting out New Brunswick's perspective are attached:

- *Fiscal Imbalance and Equalization: A New Brunswick Perspective*, Fall 2001
- NB Finance Minister's submission to the Standing Senate Committee on National Finance in regards to the Equalization Program, October 2001
- *The Strengthening of the Equalization Program*, a paper presented to the Transfers Subcommittee, April 2003
- NB Finance Minister's submission to House of Commons Subcommittee on Fiscal Imbalance, April 2005

The current financial parameters of the program will not allow the constitutional commitment to be achieved. The funding level in the new framework remains below the level that would result from incorporating a national-average standard and restoring full revenue coverage in a representative-tax system, or "RTS", based program.

The province will continue to pursue a formula-determined entitlement using an RTS-based approach, including the national-average standard and full revenue coverage. This would better enable the program to meet its constitutional objective.

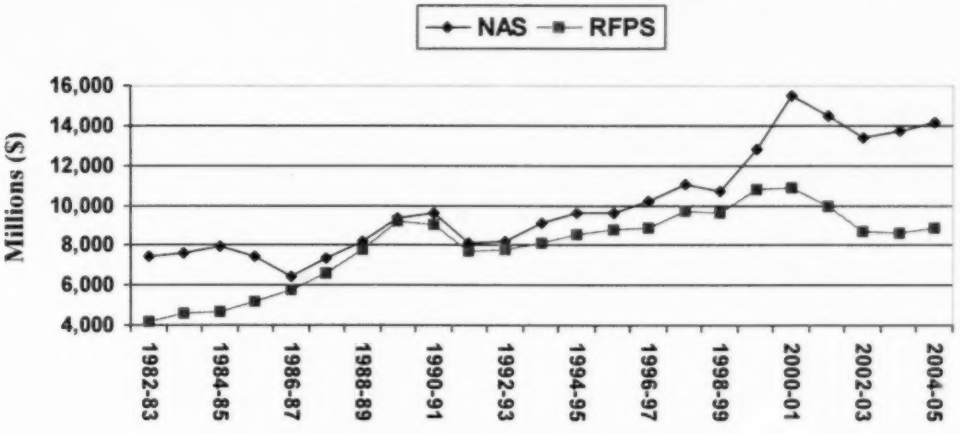
The province remains a strong supporter of the current RTS-based approach to Equalization. The RTS is founded on the actual taxation practices of provinces and is thus the most appropriate measure of fiscal capacity across the country. The province recognizes that there are challenges associated with the RTS; however, challenges would also exist under alternative mechanisms.

National Average Standard

The government believes that a *national-average standard would more accurately reflect the level of fiscal disparities throughout the country and is more consistent with the intent of the constitutional commitment.* A national-average standard would provide a more accurate and true measurement of the degree of fiscal disparities that exist throughout the country by taking into account the fiscal capacity of all ten provinces. Many other program commentators have also called for a national-average standard.

From 1982-83 to 2004-05, a national-average standard would have provided recipient provinces with an estimated, additional $48 billion in equalization, of which approximately $2.6 billion would be attributable to New Brunswick. On average, this would have represented an annual incremental outlay of approximately $2 billion for the federal government, with New Brunswick receiving over $100 million more annually.

Equalization Entitlements Under Current Five-Province Standard And National-Average Standard



The two concerns generally attributed to a national-average standard are those of volatility and affordability, primarily related to the inclusion of Alberta's fiscal capacity from non-renewable resources in the standard.

New Brunswick acknowledges that in times of high oil and gas prices, a national-average standard may raise affordability concerns. Provincial-territorial finance ministers examined this issue a few years ago and offered possible solutions, including the use of a moving-average for resource revenue yields to help mitigate volatility and affordability issues. At the same time, the federal government is in a surplus position and is anticipated to have fiscal flexibility moving forward as large and growing surpluses are projected.

A national-average standard would also help to alleviate "tax-back" concerns for certain non-renewable resource revenue sources that result from the use of the current program standard.

It should be noted that implementing a national-average standard would not achieve its desired result in an environment where total program funding is capped.

Comprehensive Revenue Coverage

One of the inherent principles of the Equalization Program is that of comprehensive revenue coverage. Since the program's inception, revenue coverage has been expanded to include most all provincial-local own-source revenues. Comprehensive revenue coverage ensures that fiscal disparities that result from the various provincial-local revenue sources are captured in determining equalization entitlements.

Revenue coverage has two dimensions: one is in terms of coverage of the various own-source revenues available to provincial-local governments, and the second is the degree of coverage of these revenue sources.

Currently, there are 33 revenue sources subject to equalization that capture to a large extent the various own-source revenue sources available to provincial-local governments.

In regards to the degree of coverage of revenues, less than 50% of provincial-local revenues from the sale of goods and services are equalized. As a result, fiscal disparities are understated and equalization payments have been reduced. From 1999-2000 to 2004-05, it is estimated that this reduction in revenue coverage resulted in foregone revenues to recipient provinces of nearly $1.8 billion, and close to $200 million for New Brunswick alone.

New Brunswick considers comprehensive revenue coverage to be an important, and fundamental, principle of a fair and equitable Equalization Program. *In order to ensure a comprehensive measure of a province's ability to raise revenues, all provincial-local own-source revenues must be fully included. This includes revenues from the sale of goods and services and resource revenues.* These revenues contribute to differences in provincial fiscal capacity, with resource revenues one of the major contributing factors to fiscal disparities across the country.

The bilateral offshore accords reached with Newfoundland and Labrador and Nova Scotia have resulted in some parties calling for a removal of resource revenues from the program. The offshore accords were made outside of the Equalization Program and provide direct benefit to the two provinces. The removal of resource revenues from the program would not only ignore the fact that they are a major source of fiscal disparities across the country, but would have implications on all equalization-recipient provinces, including considerable adverse consequences on New Brunswick. This would be unacceptable to the province.

Issues Presented in Expert Panel Paper

The expert panel paper sets out a number of issues for consideration. New Brunswick presents the following views on these issues.

Program Objectives

From New Brunswick's perspective, adequacy is the number one program objective. Funding must be adequate to allow provinces to provide reasonably comparable levels of public services at reasonably comparable levels of taxation as per the constitutional commitment.

Evolution of Adequacy

The panel has been asked to advise on evidence-based indicators of fiscal disparities that would be relevant to evaluate funding levels for Equalization in the future. It is New Brunswick's position that entitlements should be formula-determined under an RTS-based approach, with a national-average standard and full revenue coverage. The funding level set in legislation should be considered a "floor".

Multiple Equalization Standards

It is New Brunswick's view that recipient provinces should be equalized to the same per capita level through the Equalization Program. The province acknowledges that in instances where an individual province experiences a significant year-over-year reduction in entitlements, floor protection may be required that would result in differences in fiscal capacity.

Revenue Coverage

New Brunswick supports full revenue coverage within the program – in terms of the various provincial-local own-source revenue sources, and in terms of the degree of their coverage. Resource revenues are a major contributing factor to fiscal disparities and must be fully reflected in the program.

Expenditure Need

New Brunswick is opposed to introducing expenditure need measures into the Equalization Program. Not only are there a number of measurement issues, there are many conceptual issues. An expenditure-need based system would be considerably more complex than the current system.

Measuring Revenue Capacity

New Brunswick supports the continued use of an RTS-based approach to measuring fiscal capacity. The RTS is founded on the actual taxation practices of provinces, from which fiscal disparities arise. It is on the basis of actual taxation practices that the respective tax bases should be designed to the extent possible.

A macro-based approach may provide simplicity, but there are a number of concerns, including both methodology and data-related issues. A macro-based approach would also not respect the nature and design of Canada's tax system, such as the progressivity of income taxes. Economic performance is not necessarily indicative of fiscal capacity. Such an approach will also result in major changes in the allocation of shares across provinces. While simplicity may be desirable, it should not take away from the accurate measurement of fiscal disparities.

Stability and Predictability

For New Brunswick, adequacy is the most important principle. Comprehensiveness is important as well. While stability and predictability are desirable, the province is prepared to accept some volatility in order for the program to be responsive and accurately measured. Measures to address stability and predictability could be focused on major data shocks such as census impacts, as opposed to program-wide.

Transparency and Accountability

The federal-provincial-territorial committee structure and equalization renewal process provides an avenue for technical discussions on the program as well as political input and dialogue. The foremost technical experts in the country reside in the federal-provincial-territorial governments and they should continue to play a key role in the program's design and policy. That being said, the process should be opened up so that the views of other commentators are taken into consideration during the process. If a permanent body is established, it must be independent and operate at arms-length from the federal government.

Summary

The federally appointed equalization panel has been given a major challenge – to recommend to the federal government how future funding should be allocated among provinces in the context of a fixed revenue pool. Over a short timeframe, the panel is to examine a broad range of issues and alternatives in formulating its recommendations.

From New Brunswick's perspective, the current program does not meet the constitutional commitment and its adequacy must be improved.

New Brunswick's position is that, on a go-forward basis, the Equalization Program should continue to be based on a representative-tax system approach with formula-determined entitlements, and would incorporate both a national-average standard and full revenue coverage. The federal funding levels in legislation would serve as a "floor" level.

The province supports the use of an RTS-based approach and full revenue coverage, including revenues from the sale of goods and services and resource revenues.

In the interest of providing provinces with a more stable landscape for budget planning for 2006-07, the federal government should set out the allocation for 2006-07 by no later than late fall. New Brunswick is prepared to support that the same allocation share in 2005-06 be used in 2006-07, in order to provide provinces with certainty for next year, allow the panel adequate time to complete their mandate, and allow the federal government to engage provinces on possible new mechanisms.